BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIF

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Order Instituting Investigation to Consider Policies to Achieve the Commission's Conservation Objectives for Class A Water Utilities.	Investigation 07-01-022 (Filed January 11, 2007)
In the Matter of the Application of Golden State Water Company (U 133 E) for Authority to Implement Changes in Ratesetting Mechanisms and Reallocation of Rates.	Application 06-09-006 (Filed September 6, 2006)
Application of California Water Service Company (U 60 W), a California Corporation, requesting an order from the California Public Utilities Commission Authorizing Applicant to Establish a Water Revenue Balancing Account, a Conservation Memorandum Account, and Implement Increasing Block Rates.	Application 06-10-026 (Filed October 23, 2006)
Application of Park Water Company (U 314 W) for Authority to Implement a Water Revenue Adjustment Mechanism, Increasing Block Rate Design and a Conservation Memorandum Account.	Application 06-11-009 (Filed November 20, 2006)
Application of Suburban Water Systems (U 339 W) for Authorization to Implement a Low Income Assistance Program, an Increasing Block Rate Design, and a Water Revenue Adjustment Mechanism.	Application 06-11-010 (Filed November 22, 2006)
Application of San Jose Water Company (U 168 W) for an Order Approving its Proposal to Implement the Objectives of the Water Action Plan.	Application 07-03-019 (Filed March 19, 2007)

AMENDED REPLY BRIEF OF PARK WATER COMPANY ON ISSUES IN PHASE 1B

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Before the Public Utilities Commission of the State of California

Order Instituting Investigation to Consider Policies to Achieve the Commission's Conservation Objectives for Class A Water Utilities.	Investigation 07-01-022 (Filed January 11, 2007)
In the Matter of the Application of Golden State Water Company (U 133 E) for Authority to Implement Changes in Ratesetting Mechanisms and Reallocation of Rates.	Application 06-09-006 (Filed September 6, 2006)
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Pursuant to Rule 13.11 of the Commission's Rules of Practice and Procedure (Rules) and the Phase 1B briefing schedule established by Administrative Law Judge Grau's verbal ruling on the last day of evidentiary hearing, November 27, 2007, Park Water Company ("Park") submits its Reply Brief on the issues in Phase 1B of this proceeding.

I. INTRODUCTION

Opening Briefs on Phase 1B issues were filed on January 16, 2008 by Park, the California Water Association (CWA), the Division of Ratepayer Advocates

(DRA), and the Consumer Federation of California (CFC). Park offers reply to the opening briefs of the other parties as follows:

CWA Opening Brief - Park generally agrees with the positions put forth by CWA in its Opening Brief and therefore Park does not offer any reply thereto.

DRA's Opening Brief - DRA's Opening Brief adds little to what was contained in DRA's pre-filed testimony with respect to its recommendation for an "interim" ROE reduction of 50-100 basis points that would be effective upon adoption of the WRAM/MCBA. Although DRA has the burden of proof to support its recommendation for an interim ROE reduction, as pointed out by CWA (CWA Opening Brief, page 4), DRA has not made any attempt to address the many serious objections to its recommendation that have arisen in this proceeding. DRA does make a few arguments in support of an ROE adjustment which were not addressed in Park's Opening Brief. In this Reply Brief, Park responds to those new arguments and points out where DRA's other arguments have been addressed in Park's Opening Brief.

DRA's Opening Brief is silent on what methodology would measure the "stand-alone" impact of WRAM/MCBA on an ongoing basis in future cost of capital determinations. Park's position on this troublesome issue for DRA is set forth in Section III.A. of its Opening Brief.

Park does not offer any reply in its brief to DRA's argument that its recommended ROE reduction be implemented either through an immediate surcredit or used to fund conservation programs except to reiterate its position that there is no justification for an ROE adjustment at this time through either proposed method. Should the Proposed Decision (PD) in this proceeding include the adoption of an ROE reduction to be implemented prior to the effective date of the next regularly scheduled cost of capital determination, Park will provide comments on the implementation mechanism set forth in the PD.

CFC's Opening Brief - CFC's Opening Brief reargues the issue of whether a WRAM is warranted, a Phase 1A issue, and attempts to use its arguments on the adoption of a WRAM as an argument for adopting DRA's recommended ROE adjustment. CFC's arguments on this issue contain numerous mischaracterizations of

the record, misrepresentations or misunderstandings of regulatory mechanisms, and misapplication of Commission precedent. Park's Reply Brief demonstrates that CFC's arguments are not well-founded.

II. REPLY TO DRA

A. Certain of DRA's Arguments are Already Addressed in Park's Opening Brief

At the beginning of Section III (page 5) of its Opening Brief, DRA briefly discusses the methodology for its 50-100 basis point recommended ROE adjustment. In Section IV (page 9), DRA amplifies its discussion of its basis for this recommendation and claims that it is reasonable and fair. Park's Opening Brief, Section III.B, pages 14-25 demonstrates why DRA's recommendation is not reasonable and that DRA has provided no support for its recommendation.

Section IV of Park's Opening Brief (pages 27-31), and especially Section IV.A.5 (page 30), demonstrates the fundamental unfairness to the utilities of DRA's recommendation. DRA's recommendation for an interim downward ROE adjustment for the utilities would have the Commission ignore all other increased risk factors which the utilities face in favor of the single risk factor, as to which there is little if any evidence of any impact on the utilities other than a minimal impact on ROE.

DRA (page 8) refers to the testimony of Mr. Hulse in Exhibit 20. Mr. Hulse found that research publications had reacted favorably to the implementation of decoupling mechanisms in the gas industry as they have in connection with the potential implementation of WRAMs for the California water companies. DRA omits to mention, however, that Mr. Hulse found that this positive reaction from research publications has not translated into a sustained increase in the utilities' share prices and therefore did not appear to reduce their cost of equity (Park Opening Brief, page 19).

DRA also fails to discuss the other problems arising from its reliance on research publications to support its recommendation. Park discusses these problems in Park's Opening Brief, Sections III.B.1.b (pages 17-18) and III.B.2.b (pages 19-21).

B. DRA's Position on ROE Adjustment Between GRCs is Inconsistent and Circular.

DRA argues (DRA Openings Brief, pages 5-7) that currently authorized ROEs of the utilities reflect a balance of risk/reward that is presumptively reasonable. It further contends (page 7) that with the Commission's adoption of the regulatory mechanisms, WRAM/MCBA requires reducing their authorized ROEs to preserve that presumptively reasonable existing risk/reward balance. DRA's argument is circular and inconsistent.

DRA states (page 6):

> "Absent any decision in this proceeding, the currently authorized returns of each company, and the current assignment of risks to ratepayers and shareholders, would continue until the Commission's next review of the company's cost of capital. The current balance of risk and reward for each company, therefore, is presumptively reasonable."

In other words, the presumption of reasonableness is based on the fact that the Commission does not adjust a company's ROE between its regularly scheduled comprehensive analysis of a company's entire cost of capital that occurs in the GRCs (or the new water cost of capital proceedings). If DRA's recommendation to adjust a company's ROE between cost of capital reviews were followed, it would invalidate the very premise upon which DRA bases its "presumptively reasonable" argument.

DRA correctly observes that the Commission does not, and has not, adjusted the ROE of water, or other, companies between their GRCs (or cost of capital proceedings) even when the Commission adopts ongoing changes in regulatory mechanisms or procedure as is being considered in this proceeding (Exh 23, pages 3-5; TR 937,1-TR938,24).

The presumption of reasonableness that DRA refers to arises not just from the fact that the Commission sets an ROE that will be in effect until the company's next GRC or cost of capital proceeding. It ultimately arises from the presumption that the Commission acts reasonably. It is illogical of course to assume that no changes will occur between a company's GRC proceedings that may affect the appropriateness of its current ROE. Therefore, when the Commission adopts an ROE that will be

effective until the next GRC, the Commission anticipates that changes will occur before the next proceeding and either takes account of these changes in setting the ROE or assumes that the effects will cancel out in the long-term. DRA witness Murray agreed as she explained that the effect of changes between GRCs is built into the ROE:

> In my view, I guess, that's - - that risk of those factors changing was one that was always anticipated that the companies would bear between their rate cases.
>
> It's not necessarily a risk from things that the Commission has done to you so much as the world changes. And in some sense that should already - - I realize it sounds strange - - but should already be built into your ROE because the stock prices of utilities and the factors that are used always anticipate that kind of risk, what happens between rate cases. (TR 942, 20-TR 943, 2).

Ms. Murray then attempts to distinguish the adoption of the WRAM/MCBA from the other between-GRC changes that she recommends be ignored in determining whether a company's ROE should be adjusted.

> And as I said in my previous answer, that's partly because I believe that implicitly you have already been compensated for the ordinary risk of dealing with those other factors. And it is the fact that this Commission is undertaking an action on its own that's really changing the playing field in a major way that makes me feel something should happen in between the ordinary process of setting ROE. (TR 943, 10-22)

The distinguishing factors that DRA cites above to justify the unorthodox approach it is recommending are: (i) an action on the Commission's own motion; and (ii) a change that has a major impact on the utility. Action on the Commission's own motion, however, is not a distinguishing factor. The Commission often changes regulatory procedures through a proceeding on its own motion, an Order Instituting Investigation (OII) or an Order Instituting Rulemaking (OIR), but does not adjust the ROE of the companies affected by the regulatory change; the maintenance and later revocation of the earnings test on balancing account recovery, the Rate Case Plan, and the change in allocation of gain on sale, are all examples of such cases (Exh 23, page 4; Exh 24, page 4; Exh 22, page 4). While DRA consistently claimed that the WRAM/MCBA will have a major impact on the utilities' ROE, DRA has not provided any support for that claim. All the evidence in this proceeding indicates a

minimal affect of WRAM/MCBA on the ROE of water companies (see Park Opening Brief, pages 14-25).

DRA's claimed distinctions between the adoption of the WRAM/MCBA and other factors which affect a water company's ROE between regular ROE settings simply do not exist. The WRAM/MCBA is just another one of those changes that regularly occur between ROE proceedings. These changes include changes in regulatory procedures and increases or decreases in other systematic and unsystematic risks, which the Commission anticipates will occur between proceedings, the effects of which the Commission anticipates will balance out over the long-term or be taken into account in the next rate setting proceeding. Adjusting ROE for the WRAM/MCBA on a stand-alone basis between regular ROE settings as DRA recommends will simply create asymmetry in the regulatory process and invalidate the presumptive reasonableness of Park's currently authorized ROE. Logically, there can only be one conclusion to an argument which begins with the statement that the authorized ROE is presumptively reasonable because it is not changed between GRCs: that it would not be reasonable to change ROE between GRCs.

C. The Suburban and San Jose Settlements Do Not Demonstrate Inconsistency in the Utilities' Position

DRA refers to arguments made by utilities (DRA Opening Brief, page 9) that arguments made by utilities that the primary effect of the WRAM/MCBA is to offset the increased risk that would otherwise result from implementing conservation programs and conservation rates without a decoupling mechanism are inconsistent with the fact that Suburban Water Company (Suburban) and San Jose Water Company (SJW) entered into settlements which included conservation rates and a Monterey-style WRAM, rather than a true decoupling mechanism, because there has been no suggestion of an increase to adopted ROE in this proceeding for these two companies. DRA's argument is flawed because it ignores company-specific differences. There is no inconsistency.

The increased risk arising from water conservation is the consistent probability that a company's revenues will be insufficient to cover its reasonable costs. This situation, in the water conservation context, is often referred to as the "financial disincentive". Unlike Park and other companies, however, neither Suburban nor SJW have this disincentive to conserve.

The Motion of DRA and Suburban to Approve Settlement Agreements, filed April 24, 2007, states on page 13: "The reputed disincentives to water conservation absent a conventional WRAM do not apply in the case of Suburban because at peak production levels, which often occur in the summer months, the marginal costs of the most expensive purchased water sources often exceed the authorized quantity rates under the current uniform rate structure." (emphasis supplied). For different reasons, The Motion of DRA and SJW to Approve Settlement Agreements, filed November 14, 2007, states on page 13 that the disincentives to water conservation that water utilities are reputed to have absent a conventional WRAM do not apply to SJW.

Accordingly, because these two companies do not have financial disincentives to water conservation, there is little if any increased risk resulting from such conservation that would require mitigation by a WRAM/MCBA. It is therefore not surprising that there has been no suggestion that increased adjustment to ROE for those companies in this proceeding. Park notes, however, that the Settlement Agreement between DRA and SJW on Conservation Rate Design Issues (Attachment A to the Motion referenced above), on page 11, states that while neither party will seek an adjustment to ROE, up or down, for the period covered by the settlement; SJW retains the right to request an ROE adjustment in its next cost of capital proceeding. Park submits that the reason there have been no suggestions of increasing ROE adjustments in this proceeding is that the only parties advocating any ROE adjustment in this proceeding are DRA and CFC. The position of the water companies is that any consideration of changes to ROE that relate to the adoption of a WRAM should be dealt with in the next scheduled cost of capital determination.

D. DRA's Positions in Prior Proceedings Do Not Constitute Support for its Position in This Proceeding

In an attempt to provide support for its position on the ROE impact of a WRAM in this proceeding, DRA (Opening Brief, page 11) points to consistency between this position and its position in recent proceedings for CWS and Cal Am. As DRA notes, however, in both of these cases the Commission declined to adopt a WRAM and therefore did not address the impact of a WRAM on ROE. DRA has not offered any showing that the Commission relied at all on DRA's recommendations in these proceedings. DRA's prior recommendations do not have any greater underlying validity than its recommendation in this proceeding, which essentially is an unsupported opinion. DRA cannot validate its current opinion by referring to its own earlier opinion. If that constituted validation, then Park could likewise state that its position on this issue in prior proceedings is consistent with its position in this proceeding: that the ROE impact of a decoupling WRAM is minimal.

E. DRA's Recommendation Would Negatively Effect Utilities' Financing and Is Contrary to the Commission's Objective to Promote Infrastructure Investment

DRA states (page 12) that it recognizes that an ROE reduction consistent with its unsupported opinion that the WRAM/MCBA would reduce the utilities' ROE by some 250 basis points could adversely affect their ability to obtain debt financing on favorable terms. DRA implies, without any showing or even any direct claim, that its recommended 50-100 basis point reduction would not have such an affect, simply because it has been moderated from DRA's initial unsupported opinion. The evidence in this proceeding indicates otherwise.

Ms. Abbott testified that "Any attempt to maintain or improve credit quality by introducing a WRAM would be adversely affected by a diminution in allowed returns on equity" (Exh.43, page2, para.9). Ms. Abbott further testified that a reduction in allowed returns is ill-advised, stating "However, the resulting decrease in

cash flow available to cover fixed obligations that would result from a decrease in allowed returns would aggravate the financial challenges water companies face relative to the need to invest large amounts of capital to comply with federal and state drinking water standards and to replace and improve infrastructure." (Exh 43, page 11, para.50). Mr. George testified to the increasing constituent identification and control associated with water quality compliance (Exh. 31, page 5) and to the existence of a period of high capital investment requirements (TR 843, 17-28). It is clear that DRA's recommended 50-100 basis point ROE reduction, if adopted, would negatively impact the ability of water utilities to obtain debt financing on favorable terms and would also increase the probability that they would have difficulty in accessing the debt market at all.

Further, publicly-traded companies already have difficulties in raising equity capital. Value Line's publication of October 26, 2007 on CWS, while it includes a positive reaction to then proposed WRAM, states "Capital requirements pose a problem though." And concludes "Investors have better options elsewhere.". With respect to American States Water, parent of GSW, while there is again a reference to the WRAM, Value Line concludes "Nevertheless, the stock lacks investment appeal." and "Income-minded investors have better options, also, given the capital constraints we suspect the company faces." (Exh. 42). If Value Line is not currently recommending the purchase of stock in these companies, a reduction to their authorized ROEs can only have a negative impact on equity financing.

Objective Number 3 in the Commission's Water Action Plan (WAP), issued on December 15, 2005, is to promote water infrastructure investment. The Commission states "The water infrastructure in California needs significant improvement. We will provide financial incentives and direction to encourage investment in infrastructure needed to improve water quality." (WAP, page 4). Park submits that the adoption of DRA's recommendation to reduce the water utilities' ROE at this time conflicts with this objective.

F. DRA Misstates Park's Position on ROE Adjustment

DRA states (Opening Brief, Page 14) "Any ROE adjustment adopted in this proceeding should be implemented at the same time that the company implements the relevant conservation rates and accounting mechanism. No party has questioned or challenged this approach." (emphasis added). The preceding sentence is not accurate.

Park has clearly opposed any ROE adjustment at the time that the WRAM/MCBA and conservation rates are implemented (see park Opening Brief, pages 28-32). Park's position is not conditioned upon whether or not the Commission decides to assign some ROE impact to the WRAM/MCBA. If the Commission should conclude that the impact of the WRAM/MCBA warrants a reduction to ROE of 10 basis points on a stand-alone basis, Park's position continues to be that the ROE should not be changed without considering the other risk factors that would bear upon the reasonable ROE for each of the water companies.

G. The 20 Basis Point ROE Reduction in the Drought Memorandum Account is Not a Precedent for DRA's Recommendation of an "Ignore-Other-Risk-Factors" ROE Adjustment, Regardless of How it is Implemented

DRA (Opening Brief, page 18) attempts to reconcile the differences in implementation between the methodology used for the 20 basis point ROE reduction adopted in 1991 for the Drought Memorandum Accounts in the Drought OII (netting out the dollar impact of the reduction against amounts to be recovered in the memorandum account) and DRA's recommendation in this proceeding that the Commission adopt an ROE reduction on a stand-alone basis for the WRAM/MCBA and implement it through a surcredit timed to be effective upon the implementation of the WRAM/MCBA.

It is clear from this attempted reconciliation that, despite the different circumstances associated with the Drought OII (see Park Opening Brief, pages 29-30), DRA continues to view the Commission's decision to offset recovery of balances in the Drought Memorandum Account by the dollar-impact of a 20 basis point ROE

reduction as a precedent for its recommendation in this proceeding. This recommendation would have the Commission adopt a stand-alone ROE reduction for the WRAM/MCBA without any consideration of other risk factors; rather than incorporating whatever change in risk may result from the WRAM/MCBA into its next scheduled ROE determination where it can be weighed with all factors impacting ROE. The Commission has traditionally taken this approach for changes in on-going regulatory procedures affecting water companies, and it also deferred any consideration of an ROE adjustment until the next GRC when sales adjustment mechanisms were adopted for energy companies. The Commission's decision in the Drought OII is not a precedent for DRA's recommendation in this proceeding because the Commission in that proceeding did not reach its decision in isolation from other risk factors facing water companies as DRA now recommends.

A circumstance that has not been brought out in the record of this proceeding is that when the Commission adopted the 20 basis point offset to recovery from the Drought Memorandum Account in D. 91-10-042, the Drought OII (I.89-03-005) had been consolidated with I.90-11-033, "Investigation on the Commission's own motion into the financial and operational risks of Commission regulated water utilities, and whether current ratemaking procedures and policies require revision.", commonly referred to as the Risk OII. That consolidation occurred with the issuance of the Risk OII because the Commission recognized that there were issues arising in the Drought OII associated with risk. The Commission stated (I.90-11-033, page 7): "In order to promote a coherent and coordinated review of issues which affect risk and return, we are ordering that the Drought OII and the Connection Fees OIR be consolidated into this proceeding." The Commission, in D. 91-10-042, the decision adopting the 20 basis point ROE offset, stated (page 23): "We also must recognize that the risk issues we consider today can not be taken in isolation. We will consider this matter in the whole context of utility industry risk in the risk OII, I.90-11-033."

It is clear that the Commission's decision in the Drought OII considered other risks and regulatory procedures affecting water companies at that time. It is not a precedent for the "lets only look at this one thing in isolation" approach that characterizes DRA's recommendation in this proceeding.

III. REPLY TO CFC

In the following replies to CFC's Opening Brief, Park has given citations to the sections of the brief containing the specific arguments to which Park is providing reply and where reasonable, some indication of the location of specific arguments within the section. Page number citations have not been provided since the pages of CFC's Opening Brief are not numbered.

A. CFC's Argument Against Adoption of a WRAM is Untimely and Unrealistic

The initial sections of CFC's brief are largely arguments against the adoption of a WRAM, the position taken by CFC in Phase 1A of this proceeding. With respect to the settlements between DRA and Park, GSW, and CWS, these arguments are untimely and misplaced. The issue as to whether to adopt the WRAM/MCBA mechanisms was an issue in Phase 1A of this proceeding and CFC's arguments belong in its comments to the Proposed Decision on Phase 1A rather than its brief in Phase 1B. Furthermore, CFC's argument (Sections B. and C.) that utility managers should be expected to manage their companies in a manner that will result in the companies achieving revenue levels that were estimated when rates were established, despite the subsequent implementation of that conservation rates and programs, simply ignores the realities of regulated utility operations.

B. CFC's Arguments that the "Unnecessary" Adoption of a WRAM Justifies a ROE Adjustment Contain a Number of Mischaracterizations

In Section D of its Opening Brief, CFC argues that "No piecemeal adjustment of test year costs is necessary, but if the WRAM is allowed, an adjustment to equity cost is equally justified." This statement implies, without any direct statement or justification, that the adoption of a WRAM is a piecemeal adjustment. CFC states that the arguments by utilities against piecemeal adjustment to ROE "apply equally to the adjustment of test year revenues and costs proposed through operation of a WRAM". Park responds to this assertion as follows:

1) A WRAM does not adjust test year revenues; a WRAM simply insures that the commodity rate portion of the adopted test year revenue is received.

2) On the second page of Section D, CFC points to a Commission decision on a PG&E application that discusses the Commission's policy on offset rate relief for increases in a utility's costs. This discussion is not germane. The offset rate relief process does result in an increase to the adopted revenue requirement, unlike the WRAM. CFC emphasized a reference in that decision to offsets for conservation expenses. There is no offset rate relief under consideration for conservation expenses, however, in this proceeding; the proposal in this proceeding is for conservation expenses to be tracked in memorandum accounts. As those accounts are subject to reasonableness review, this should address the Commission's stated concern (immediately prior to the statement emphasized by CFC) regarding potential duplication in authorized expenses. CFC also emphasized a statement in the PG&E decision it cites that the sound regulatory procedure is to consider all utility expense components in a general revenue requirement proceeding which, given CFC's quote from Mr. Jordan that "ROE is a part of the cost of capital not unlike other costs which are estimated to determine the utilities revenue requirement.", only justifies Park's position that adjusting the ROE would be a piecemeal adjustment whereas adopting a WRAM, which does not change the revenue requirement, is not.

3) CFC argues (second page of Section D) that, while utilities have criticized DRA's proposed ROE adjustment as speculative, a WRAM is equally speculative. First, the citations provided by CFC for the utilities criticism do not include any testimony that an ROE adjustment is "speculative". The pages cited by CFC contain arguments regarding the potential for duplication of effect if a separate, piecemeal, ROE adjustment is adopted, the very concern of the Commission in the decision cited by CFC. Second, the WRAM is not speculative. The WRAM will produce a precisely known result. The utility will actually receive the adopted commodity rate revenues, less production cost savings. Attempting to make an adjustment to the adopted sales levels to anticipate the effects of conservation programs and rate designs would be speculative.

4) At the end of Section D of its Opening Brief, CFC makes several statements apparently designed to make the WRAM appear unnecessary undesirable and, therefore, a reason for a downward ROE adjustment. The support in the record implied for these statements by CFCN does not exist.

a) CFC states "To the extent there is any reduction in revenue from conservation, 'it is undoubtedly very small.' (Ex. 25, Zepp at 3)". What Dr. Zepp actually testified at page 3 of Exhibit 25 was: "To the extent that there is any reduction in risk and required ROE from a WRAM, it is undoubtedly very small." (emphasis supplied). He made no such statement about reduction in revenues.

b) CFC states that conservation rates are not likely to have any immediate impact on revenue. CFC follows that with a quote from Mr. Jordan wherein Mr. Jordan opines that the combination of conservation rates, conservation programs, and communications to customers will be effective to promote conservation and that conservation rates are not the sole driver of conservation. Mr. Jordan did not say that conservation rates are not likely to have any immediate impact. Further, customer outreach programs, as well as other conservation programs will be implemented coincident with the WRAM. The WRAM will be necessary to mitigate the impact of water conservation regardless of whether that conservation is caused just by conservation rates or a combination of rates, programs and customer outreach.

c) CFC states that the WRAM/MCBA is likely to increase customer bills and that "the MCBA will capture rate increases which are anticipated in the near future from purchased water suppliers. (TR 750)" The record shows that those increases would be picked up by the existing unit cost balancing accounts even if the WRAM/MCBA were not adopted (TR 750, 2-8; TR750, 20-TR 751, 1).

d) CFC states that "According to Mr. George, it is unlikely that ratepayers will see any savings from their water conservation efforts. (TR 843)". What Mr. George actually said (TR 843, 17-28) was that "During a period of high capital investment such as is contemplated now and in the years ahead, rate

payers may not see any savings from the conservation efforts…". Mr. George is clearly referring to the potential for high capital investment to cause increases in revenue requirement, and therefore rates, which would offset the impact of reduced consumption on customer bills. This has no bearing on CFC's argument.

C. The Adoption of a WRAM/MCBA, Along with Conservation Rates and Programs, Results in Balance and Does Not Justify a ROE Adjustment

CFC, in its argument that the adoption of a WRAM is a piecemeal adjustment which throws things out of balance and warrants the adoption of a piecemeal ROE adjustment, cites several U.S. Supreme Court decisions (Section A.). CFC does not cite, however, the following standards regarding a utility's returns set forth by the U.S. Supreme Court the in its Bluefield Waterworks decision:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economic management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally. 262 U.S. 679, 692-93 (1923).

The Commission has recognized, specifically in the case of energy companies and implicitly in the Water Action Plan, that the pursuit of water conservation through programs and conservation rate designs, with sales estimates developed without consideration of the conservation effect, does not permit a utility to have any

expectation of earning a reasonable return on its investment on an ongoing basis, absent a sales adjustment mechanism like the WRAM.

CFC's attempts to portray WRAM as a piecemeal adjustment are shown by Park to be unsuccessful in Section III.B above. In view of the adverse effect on Park's revenues that will result from water conservation, the WRAM, or some other mechanism or change in mechanisms, is necessary to restore the ability of Park to earn the "reasonably sufficient return" mandated by Bluefield.

As discussed above in Section III.B, adopting memorandum accounts for conservation expenses does not meet the definition of piecemeal adjustment expressed in the Commission's decision on PG&E's application. The adoption of these memorandum accounts for expenses of the utilities associated with new conservation programs and activities arising from this proceeding is necessary because these programs and activities have not been provided for in rates; and because the WRAM only allows recovery of adopted commodity rate revenues less production cost savings, there is little potential for a company's revenues that exceed its estimated revenues to be available to meet these additional costs. The memorandum accounts provide balance to the increased costs.

In addition to its primary effect of mitigating the increased risk that would otherwise result from the implementation of conservation programs and conservation rate designs, the WRAM/MCBA will also smooth out random volatility (unanticipated variances with equal chance of positive or negative sign) due to revenue estimating error related primarily to weather. It will also mitigate the impact of reduced sales during a drought. The latter fact, however, should not result in any reduction to ROE, however, because: 1) the Commission's authorized sales forecasting method does not include any allowance for drought and therefore, absent an increase in ROE to compensate for the risk of droughts, some provision must be made in the interest of regulatory equity; and 2) investors simply expect that, under extraordinary circumstances, such as a drought, the Commission will provide extraordinary relief (Park Opening Brief, page 2).

As demonstrated in Park's Opening Brief, the remaining mitigation provided by WRAM/MCBA, the smoothing out of random volatility of revenues due to

estimating error related primarily to weather, especially when combined with other new risks resulting from conservation which are not mitigated by the WRAM/MCBA, results in a minimal decrease in risk that is unlikely to be important to investors.

As discussed in Section II.B. above (in reply to DRA), the adopted ROE is set with the expectation that factors impacting risk, including changes in regulatory mechanisms, will change between cost of capital determinations. Therefore adjusting a water company's ROE between its cost of capital determinations in order to take into account the effect of a single risk factor (that is assumed to decrease), without taking all risk factors into account, creates asymmetry rather than balance. The WRAM's effect of smoothing out random revenue volatility due to estimating error related primarily to weather does not justify a ROE reduction, especially as other utility risks have increased. Accordingly, the issue of ROE impact should be dealt with in the next scheduled cost of capital determination.

D. Ms. Abbot's Testimony, Absent CFC's Mischaracterization, is That a ROE Reduction Will Unbalance the Equation

On the second page of Section E, CFC states "The CWA's witness, Ms. Abbot, appears to agree with Ms. Murray. She testified that an ROE adjustment, when coupled with WRAM, "puts you in the same place you started.' (TR1039)". CFC mischaracterizes Ms. Abbott's testimony.

The citation provided by CFC is to a statement in the middle of Ms Abbott's summary of her testimony at hearing (TR 1038, 10- TR 1040, 10), at the end of which Ms. Abbott concludes "you don't achieve a diminution in risk by putting in a WRAM and at the same time reducing the return on equity. And the adjustment clause itself does not, in the minds of the real-life investor, reduce the risk of the companies." Ms. Abbott's pre-filed testimony included a summary in which Ms. Abbott testified that "Any attempt to maintain or improve credit quality by introducing a WRAM would be adversely affected by a diminution in allowed returns on equity" (Exh.43, page2, para.9).

When taken in the context of Ms. Abbott's pre-filed testimony and her summarization and conclusion at hearing, it is clear that Ms. Abbott's testimony is that if a WRAM is implemented to mitigate the risk of water conservation, and there is a corresponding reduction in a company's adopted ROE, it would put the company back in the same position it was before WRAM was adopted. Reducing the ROE effectively undoes the risk mitigation provided by the WRAM. The combination of a WRAM and a reduction to adopted ROE simply replaces the negative effect on a company's earnings resulting from conservation without WRAM, with the negative effect on those earnings resulting from a reduction in its authorized ROE. The result is the same in either case: a negative effect on a water utility's credit-worthiness and attractiveness to investors.

E. CFC's Argument Supporting DRA's ROE Adjustment Recommendation is based on Non-comparable Examples and Confuses the Effect of Cost Adjustment Mechanisms with Sales Adjustment Mechanisms

In the beginning of Section E of CFC's brief, CFC quotes Dr. Vilbert's discussion of the risk impact of fuel cost pass-throughs, a cost adjustment mechanism typical for gas companies which is similar to production cost balancing accounts for water companies. On the next page CFC refers to testimony presented by Dr. Zepp in an Arizona water company case that an upward adjustment in cost of equity should occur if the company's purchased power and purchased water adjustment mechanisms were eliminated, and in another Arizona case involving Chaparral City Water Company, wherein Dr. Zepp recommended that the company's ROE should be increased by 60 basis points if it were not allowed to implement its requested purchased power and purchased water adjustment mechanisms. CFC also refers to a similar recommendation of Dr. Vilbert in a Pennsylvania case associated with a purchased power adjustment mechanism. CFC points to this testimony by Dr. Vilbert and Dr. Zepp as an indication of inconsistency in the utilities' position and as support for DRA's recommendation of an ROE adjustment if the WRAM/MCBA is adopted. This testimony is not inconsistent and provides no such support because these other

cases are not comparable, and because the risk impact of cost adjustment mechanisms is different than the risk impact of sales adjustment mechanisms.

1. The Other Cases are Not Examples of DRA's "Stand-alone" ROE Adjustment Recommendation

With regard to Dr. Zepp's testimony in the Chaparral City Water Company case, CFC states "Dr. Zepp has presented testimony supporting an adjustment, like the one proposed by DRA, which recognizes the link between adjustment mechanisms and the cost of equity."(second page of Section E.).

The Chaparral City Water Company case referred to by CFC resulted in Decision No. 68176 issued by the Arizona Corporation Commission. That decision was in a general rate increase proceeding in which the company had requested purchased power and purchased water adjustment mechanisms and in which the company had offered to reduce its originally requested ROE of 11.0%, based on Dr. Zepp's evaluation of the company's risk without such mechanisms, to a request of 10.4% (page 17). [1]

The ROE adjustment in the Chaparral City Water Company case is easily distinguishable from the adjustment proposed by DRA in this proceeding. The adjustment in that case was not a "stand-alone" adjustment to the authorized ROE between cost of capital determinations. It is a case in which the impact of regulatory mechanisms on risk was considered along with all other risk factors in a cost of capital determination. Park has not checked the other cases CFC refers to but believes it likely that they were also GRC proceedings. CFC has not shown that these cases are examples of the kind of adjustment that DRA is proposing in this proceeding.

2. The Other Cases Are Distinguished by Different Regulatory Mechanisms

The decision on the Chaparral City Water Company case states that the application was filed August 24, 2004 for the Test Year ended December 31, 2003.

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[1] In the matter of the application of Chaparral City Water Company, an Arizona corporation, for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for utility service based thereon, Docket No. W-02113A-04-0616; Decision No. 68176, September 30, 2005; Arizona Corporation Commission, 2005 Ariz. PUC Lexis 169

Arizona uses a historic test year. At least two of the three cases cited by CFC are Arizona cases in a historic test year jurisdiction. In a historic test year jurisdiction, where there is no ability to forecast cost increases, a cost adjustment mechanism for purchased power and water would have a more significant impact on a company's risk than in a future test year jurisdiction such as California.

With regard to the Pennsylvania case, Dr. Vilbert testified that the electric utilities in Pennsylvania were operating under a rate cap mechanism requiring them to purchase power at a very high cost and then sell it at a low capped rate; resulting in significant losses. Dr. Vilbert explained that it was this Pennsylvania mechanism and the amount of the loss which was responsible for the size of his recommended ROE adjustment should a cost adjustment mechanism not be approved (TR 855, 19-TR 856, 9).

3. Cost Adjustment Mechanisms Affect Systematic Risk While Sales Adjustment Mechanisms Primarily Affect Unsystematic Risk

At the beginning of Section E, CFC states that "..adoption of purchased gas adjustment clauses, which are similar to a WRAM, shifts risk to ratepayers." The mechanisms are similar only in that they are both adjustment mechanisms, but what is being adjusted, the resulting impact on risk and the type of risk affected, and therefore the impact on ROE, are very different.

The WRAM adjusts a company's revenues from actual sales to revenues from adopted sales. Cost adjustment mechanisms adjust from adopted production costs to actual production costs. The differences between a company's adopted and actual sales will average out anyway in the long term because these differences are primarily weather-related and because the method for arriving at adopted sales was developed jointly by the Commission and the water utilities and agreed to with the specific expectation of that averaging out effect (see park Opening Brief, page 21). There is no such specific expectation in connection with estimating production costs. While sales of water will tend to increase and decrease due to weather, costs of electricity, gas, purchased water, etc. generally increase, Therefore, there is a greater potential for asymmetry in the process of estimating these costs. The risk associated with

smoothing out of the sales differences does not equate to the risk associated with recovery of production costs.

More importantly, the type of risk that is reduced in each case is different. There has been much discussion in this proceeding about the distinction between systematic risk, which changes with general economic conditions, and unsystematic risk, which does not change with general economic conditions and is therefore diversifiable. The risk of fluctuation in water sales reduced by the WRAM is primarily weather-related; the risk of changes in source mix, the additional protection provided by the MCBA, is operations-related. Therefore, the risk that is mitigated by WRAM/MCBA has only minimal relation to changes in the general economy (see Park Opening Brief, pages 10-11). Dr. Vilbert and Dr. Zepp have both testified that weather is an unsystematic, or diversifiable, risk (see Park Opening Brief, pages 11-13).

Cost adjustment mechanisms for fuel or production costs track differences between a company's adopted and actual unit costs of production, its costs per unit of purchased power and gas, and its purchased water costs (as in the current ICBA, or, as in the case of MCBA, both differences in unit costs and source mix). While the mix change protection provided by the MCBA is related to operational considerations, the unit costs tend to change with general economic conditions (TR 720, 1-8). The risk that is mitigated by the implementation of a cost adjustment mechanism that tracks changes in unit costs is, therefore, largely systematic risk rather than unsystematic or diversifiable risk.

Dr. Vilbert and Dr. Zepp have both testified that reduction of unsystematic, or diversifiable, risk will have little, if any, impact on a company's ROE (see Park Opening Brief, pages 9-10). The acknowledgement by the utilities' witnesses of the impact on ROE of mitigating systematic risk by implementing cost adjustment mechanisms is not inconsistent with their position with respect to the ROE impact resulting from the mitigation of unsystematic risk by sales adjustment and source mix adjustment mechanisms such as WRAM/MCBA. Further, because of the different nature of the risk being mitigated, the ROE impact associated with cost adjustment

mechanisms is not relevant to the ROE impact associated with WRAM/MCBA and does not provide any support for DRA's recommended ROE reduction.

F. CFC's Conclusion is Based on Misconceptions

In the conclusion of its brief CFC states that the WRAM proposed by CWS, Park, and GSW "guarantees full recovery of revenues (and costs recorded in he MCBA account), whether or not the changed levels of revenues and costs result from conservation efforts. If a piecemeal adjustment to revenues and costs is implemented, some recognition must be given to the fact that the utilities' risk of not earning allowed revenues has been reduced." Aside from the misstatement that the WRAM guarantees full recovery of a utility's revenues rather than just its commodity rate revenues, CFC's statement mischaracterizes the effect of the WRAM.

While the WRAM reduces the utilities' risk of receiving less than their authorized revenues, it also reduces their ability to receive more than their authorized revenues. These two reductions would average out except for the effect of water conservation and the only remaining result of the WRAM would be a smoothing out of fluctuations due primarily to weather. It is the implementation of conservation programs and rate designs, with their corresponding reductions in sales which are not provided for by the Commission's adopted sales forecasting method, which increases the risk that the company will not receive its authorized revenues. The WRAM mitigates that increase risk. All that remains is the smoothing out effect, not a reduction in the risk of the company receiving its authorized revenues. CFC's arguments are consistent with its position that water utilities should simply absorb the effects of conservation. They are not consistent, however, with the true picture of the effects of water conservation and the proposed WRAM/MCBA mechanism and their interaction.

IV. CONCLUSION

For the reasons discussed above, Park respectfully requests that the Commission adopt Park's position with respect to the issues discussed in this Brief.

Respectfully submitted,

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**********CERTIFICATE OF SERVICE**********

I HEREBY CERTIFY THAT I HAVE THIS DAY SERVED A COPY OF "AMENDED REPLY BRIEF OF PARK WATER COMPANY ON ISSUES IN PHASE 1B" IN I.07-01-022 BY USING THE FOLLOWING SERVICE:

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Executed on February 15, 2008 at Downey, California.

/s/ ELLEN M. ZIMBALIST
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N O T I C E

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